

State of Rhode Island and Providence Plantations
STATE INVESTMENT COMMISSION

Monthly Meeting May 26, 2010

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, May 26, 2010. The Treasurer called the meeting to order at 9:05 a.m.

Membership Roll Call. Present were: Ms. Rosemary Booth Gallogly, Mr. Michael Costello, Mr. Thomas Fay, Mr. Andrew Reilly and General Treasurer Frank T. Caprio, establishing a quorum. Also present were: Ms. Sally Dowling, of Adler Pollock, & Sheehan, and Mr. David Ursillo, of Rodio & Ursillo, Legal Counsel to the Commission; Mr. John Burns of Pension Consulting Alliance (PCA), General Policy Consultant to the Commission; Ms. Michelle Davidson of Pacific Corporate Group, Mr. Richard Davies, Mr. Chris Nikolich, Ms. Patricia Roberts, of Alliance Bernstein, Mr. William H. Hurry, Jr. and Mr. Peter Kerwin of the RI Higher Education Assistance Authority and members of the Treasurer's staff. Mr. Robert Gaudreau, Mr. Robert Giudici, Dr. Robert McKenna and Ms. Marcia Reback were not present.

State Investment Commission Minutes. Treasurer Caprio entertained a motion for approval of the minutes for the meeting of April 28, 2010. Mr. Costello moved, Mr. Fay seconded, and the subsequent motion passed. The following members voted in favor: Ms. Booth Gallogly,

Mr. Costello, Mr. Fay, Mr. Reilly and General Treasurer Caprio.

VOTED: To approve the Minutes of the April 28, 2010 monthly meeting.

General Consultant Report. Mr. Burns gave a perspective on the world financial markets. He commented that they are unstable due to events in Greece and double digit recession in Europe and fear of sovereign defaults bringing the financial system back down. He noted this has some bearing on the Rhode Island portfolio due to the exposure to Europe in the international equity portfolio. U.S. stock holdings are affected because of the global repercussions.

Over the past few months this group has been in the process of building a portfolio that is less dependent on the equity return premium. Thus far the board has set up a policy for a real return portfolio, are moving forward on the hedge fund of funds search, and have developed a policy adding commodities to the portfolio. All these steps alleviate exposure to what is going on right now.

Mr. Burns stated that previous meetings have had presentations on fixed income in general, historical returns, and the way the class works. Today the focus is on the role of fixed income or policy considerations. He proceeded by telling the group that with fixed income the general rule that investment returns are related to the risks taken is applicable. Additionally, Government sponsored mortgage-backed securities and corporate bonds will out perform equivalent U. S. Treasury obligations in the long-term. Long maturity

bonds out perform cash and short maturity notes over the long-term. He covered facets of the three types of fixed income risk, interest rate, credit and reinvestment. He then turned to active management risks that could be encountered when lower quality products are employed to outperform the benchmark.

Mr. Burns then addressed the day's principal issue, the role of fixed income. He asked the group to consider fixed income as part of the whole portfolio when deliberating policy. He then defined three usual roles for consideration: diversification to reduce volatility and risk, principal protection to guard principal and value-added to achieve the target return. He noted that this is usually the role that fixed income has taken in the last 10 years. He reviewed how a fixed income portfolio would be structured by sector to meet each one of these objectives.

Mr. Burns stated the current role of fixed income is to provide a stable investment return and generate income while diversifying assets. This portfolio has a large allocation to corporate credit - investment grade and high yield. He then moved to an overview of the existing Rhode Island portfolio by asset class, category, sector and manager and allocation percentage to provide a foundation to determine the fixed income objective. He noted a fixed income allocation of 22% will have an impact on the overall portfolio regardless of the strategy the board determines.

The group discussed the topic presented by Mr. Burns.

Ms. Booth Gallogly asked which strategy the fund reflects based on the current allocation.

Mr. Burns replied currently the fund reflects the return value added allocation.

Mr. Fay asked Mr. Burns to address correlations.

Mr. Burns stated that the correlation with equity underlies the thinking in defining the various role options.

Ms. Booth Gallogly asked that if TIPS are included in the figures we are discussing.

Mr. Burns responded that TIPS are figured in the real return portfolio. Treasurer Caprio, as a next step, asked Mr. Burns to come back with some options for the board.

Short Term Investments Collateral Policy Review. Mr. Izzo asked the board to turn to the document: Policy on Collateralization of Public Deposits Fiscal Year 2010. This policy, which was put in place by Treasurer Caprio before the markets turned down, is formalizing the initiative to have maximum protection on our state's cash. In conjunction with the Auditor General, during the past year's audit, we have produced a written policy.

Treasurer Caprio asked for a brief overview of the type of collateral we are seeking.

Mr. Izzo stated the policy requires the highest quality collateral from our vendors, issued by the U.S. government, in the form of Treasuries or agency discount notes backed by the government in the form of Federal Home Loans, Farm Credits, Ginny Mae and Freddy Macs. Again, our goal is to have the highest integrity in case there is a need to liquidate and get our money back immediately. He noted that due to market trends and situations we ask for the board to provide an

annual review to maintain safety at all times.

Treasurer Caprio entertained a motion to accept the collateral policy on public deposits as presented by Mr. Izzo.

Mr. Reilly moved, Mr. Costello and Ms. Booth Gallogly seconded, and the subsequent motion passed. The following members voted in favor: Ms. Booth Gallogly, Mr. Costello, Mr. Fay, Mr. Reilly and General Treasurer Caprio.

VOTED: To accept the collateral policy on public deposits as presented by Mr. Izzo.

Alliance Bernstein 529 Plan Contract. Mr. Dingley informed the group that Rhode Island has the second largest advisor-sold 529 plan in the country and a great partnership with Alliance Bernstein including the benefits of matching funds for low income population and scholarship funds. Last fall we hired an independent consultant to work closely with RIHEEA and to report on the 529 vendor marketplace, other states' benefits and the possibility of issuing an RFP. After several months of working with the consultant the conclusion was the existing relationship greatly benefits Rhode Island. The staff has negotiated at great length a stronger contract that RIHEEA has approved. He called on the Alliance Bernstein team to make their presentation.

Mr. Richard Davies introduced his colleagues Mr. Chris Nikolich and Ms. Patricia Roberts of Alliance Bernstein.

Ms. Roberts stated the 529 program has grown from about 1,700 to

over 500,000 accounts and about \$8.5 million to \$7.4 billion in assets in the past 10 years. There are over 22,000 accounts established by Rhode Island families.

Mr. Nikolich, senior portfolio manager, presented information on performance. He reviewed Alliance's overall year to date, three year and five year returns for the various education strategies. He then explained that the CollegeBoundfund returns for Rhode Island families are essentially the same as that of investors from the rest of the country, however, Rhode Island participants pay lower fees.

Ms. Roberts detailed the terms of the contract. She emphasized that with the implementation of the newly agreed-upon fee adjustment, Rhode Islanders will benefit from having the lowest cost age-based or passive option available to them in the nation. With respect to RIHEAA revenue, which is used for grants and scholarships there is a new asset-based formula that replaces the account fee formula to potentially garner additional revenue. Additionally, there is a provision that if the new formula produces less than the current formula, it will revert back to the current formula.

She highlighted the 'new baby program' that has been added under the contract. Every child born on or after July 01, 2010 will be eligible to receive a \$100.00 dollar starter deposit in CollegeBoundfund when the parents complete the application process and open an account within a year of the child's birth (or adoption). For each baby born after July 01, 2010, whose family does not open an account, \$50.00 will go to RIHEAA to be used in connection with various initiatives to support college access.

Ms. Roberts addressed the additional marketing and administrative support provided in the new contract. There will be an increase in the marketing budget of \$60,000 dollars totaling \$750,000 dollars a year. The \$250,000 dollars for administrative oversight of the program will remain the same and will add an additional \$25,000 for the state to use for investment oversight of the program each year. She then reviewed the technology enhancements provided for under the contract: integration of waytogoRI.org, live customer service through colledgebound.com/ri, online gifting and paperless enrolment.

The group engaged in discussion of the information presented by the Alliance Bernstein team.

Mr. Costello inquired about strategy changes in anticipation of another significant market adjustment like that experienced in 2008.

Mr. Nikolich stated that there have not been any changes to allocation. However, a lot of research has been done on mitigating short-term risk. Further discussions with the Treasury and RIHEAA staff are necessary to discuss enhancements to keep up with college inflation in the long-term, and to mitigate risk due to extreme environments in the short-term.

Mr. Fay said it was his understanding that a Rhode Islander has a unique advantage of the lowest cost structure available. He asked if that is the case.

Ms. Roberts explained that the lowest cost structure is correct and that there is nothing currently lower in the cost of age-based or passive options in 529 programs available to Rhode Island residents.

Treasurer Caprio mentioned that he is very proud of the \$100 new baby program that is also unique to Rhode Island.

Mr. Hurry pointed out that Rhode Island also has a matching program that most residents can participate in.

Mr. Fay asked what the time period of the contract is.

Mr. Dingley stated that the contract is for five years with an option to terminate or to extend for another five years.

Treasurer Caprio entertained a motion to accept the 529 contract as presented by Alliance Bernstein

Mr. Costello moved, Mr. Reilly seconded, and the subsequent motion passed. The following members voted in favor: Ms. Booth Gallogly, Mr. Costello, Mr. Fay, Mr. Reilly and General Treasurer Caprio.

VOTED: To accept the 529 contract as presented by Alliance Bernstein.

Legal Counsel Report. Legal Counsel had no report.

Chief Investment Officer Report. Mr. Goodreau reported that he is encouraged with the fund's relative performance. The 1 year returns are 166 basis points over the benchmark and the standard deviation was reduced during the same time by almost 100 basis points under our policy. Some of the performance numbers are getting stronger. The 2 year number is 110 basis points, the 3 year number is 60 basis points, and the 5 year number is 20 basis points over our benchmark. The fund had a good month at about 13 basis points over the

benchmark, and it is over the benchmark by about 37 basis points for the calendar year.

He noted that with the Russell program a good portion of our fixed income allocation is essentially indexed. The treasury portion is indexed, it is not only very cheap but it is giving us the ability to make sure there is no kind of slippage in that area and has given us a lot of latitude with the recent volatility.

Now that the data is in, the sub-committee meeting on the hedge fund of funds search is on track.

Treasurer's Report. Treasurer Caprio stated that the private equity consultant request for proposals has been advertised in national and local publications. We expect to get numerous responses to that RFP. He noted that the fund's out performance of the benchmark in all time periods has garnered attention from the national press. He and Mr. Goodreau recently met at length with a reporter from Pensions & Investments on this topic.

New Business. There was no new business.

There being no new business, the Treasurer entertained a motion to adjourn. Mr. Fay moved, Mr. Reilly seconded and the subsequent motion passed. The following members voted in favor: Ms. Booth Gallogly, Mr. Costello, Mr. Fay, Mr. Reilly and General Treasurer Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 10:08 a.m.

Respectfully submitted,

**Frank T. Caprio
General Treasurer**